Russia: A Challenging but Improving Investment Environment

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Research

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Executive Summary

- Russia's economy has benefited hugely from high international commodity prices over the past few years. The medium-term economic outlook appears robust, and the reserves generated from oil and gas revenues should offer a partial solution to some of Russia's severe structural problems.

- Russia's population is decreasing and will likely fall by 6% in urban areas in the next 25 years versus a rural decline of 30%. However, the prognosis for Moscow and St. Petersburg, where populations will likely rise in the next 10 years, is much more positive.

- Deregulation and a reduction of administrative barriers to business have occurred in Russia. Positive changes have also taken place in some institutions enforcing corporate governance laws, but progress has been slow, and the enforcement of contracts and property rights has been uneven. Also, bureaucratic corruption appears to have risen in recent years.

- Nevertheless, a significant improvement in the investment environment has occurred over the past few years as evidenced by an improvement in sovereign ratings. Rising confidence has increased international investor demand across a range of asset classes.

- Most foreign investors in Russia pursue opportunistic strategies, engaging in development, joint ventures or acquiring controlling interests, but an increasing number want to buy existing and leased assets. A growing number of institutional-investor-backed private equity funds and listed vehicles are driving demand and are focusing on Moscow.

- Moscow's real estate market is arguably the most dynamic in Europe, but the barriers to entry for foreign investors are high, and market opacity necessitates prolonged and extensive due diligence.

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Introduction

Globalization, investors' search for value and thirst for yield, and greater institutional acceptance of investment opportunities in emerging markets are widening real estate investors' opportunity set. These dynamics, plus the accession of 10 countries to the EU in 2004, have already resulted in a very great rise in the volume of real estate capital targeting Central European markets. These markets, however, are small relative to those of Western Europe, and increased investor interest has led to dramatic yield compression. (Arguably, these markets will prove too small to absorb existing capital allocations at pricing that delivers a comparable risk-adjusted return.)

At the same time, more adventurous investors are increasingly attracted to the opportunities in largely untapped markets further afield, such as Russia and Turkey. These are highly dynamic economies and, against a backdrop of increasing economic and political stability, improving business and investment environments, and rising transparency, some investors find the case for investing in these markets increasingly compelling. Moreover, while not large in terms of the existing stock of institutional-grade real estate, these countries have the capacity to become large and strategically important markets in a pan-European context over the medium to long term.

This report covers Russia, summarizing the factors underlying the improving investment environment, a key driver of the increased interest among international real estate investors. It outlines the main opportunities for investors, assesses the performance prospects for the principal property markets and highlights the potential challenges investors will likely face.

Background

Russia emerged as one of 15 newly independent states shortly after the fall of the Soviet Union in 1991. It is a transcontinental country located in Eastern Europe and Asia. At more than 17 million square kilometers, Russia is the world's largest country, more than 80% larger than Canada (9.9 million square kilometers), China (9.6 million square kilometers) or the U.S. (9.6 million square kilometers). About one-quarter of Russia (four million square kilometers) lies within Europe: this part accounts for almost 40% of the continent's area and is more than six times larger than Ukraine and more than seven times larger than France, respectively Europe's second and third largest countries by landmass.

Russia's population is about 143 million; 106 million live in the European area. (Russia's European part is 30% larger than Germany, Europe's second largest country by population).

The first post-Communist government in Russia inherited very severe economic weakness. The subsequent depression saw real GDP fall by over one-third from 1991 to 1996, making this contraction in output worse and longer than those in most other Central and Eastern Europe countries. The collapse in output, plus several years of triple-digit inflation as prices adjusted to market levels after the removal of price controls, had a severe impact on living standards: household incomes were lost via increasing unemployment or severely eroded by inflation.[1] The

[1] The true impact on living standards is hard to estimate since the transition to a market-based economy encouraged companies to understate, not exaggerate, output as they became net taxpayers rather than recipients of net subsidies.

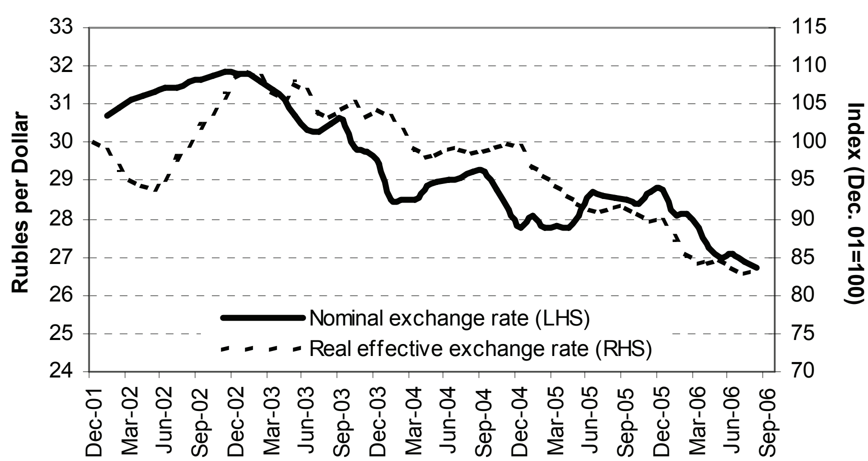
economy saw positive output growth in 1997, but the decline in output had resumed before the financial collapse in the second half of 1998. Falling prices for Russia's main export commodities, investor nervousness and aggressive monetary tightening as the Russian Central Bank tried to defend the ruble were among the factors contributing to the decline.

After the abandonment of the adjustable peg in favor of a floating exchange rate in August 1998, the ruble depreciated sharply – the real effective exchange rate fell by over 40% in the course of the year. The government then defaulted on its domestic securities and stated its need for more foreign debt restructuring. The devaluation, however, delivered a stronger than expected stimulus to economic growth, and a huge improvement in government finances followed the default. The greater competitiveness of Russian companies resulted in the growth of gross industrial output of over 10% in 1999 (the first annual rise in the post-Communist era), and record international oil prices have helped sustain the recovery. Real GDP rose by 6.7% per year from 1999 to 2005 – the best performance in 30 years and a sharp contrast to an average annual fall of 6.6% from 1991 to 1998.

An Economy in Transition

Russia is experiencing a transition from growth driven by unusually favorable conditions in the external economic environment to growth that increasingly depends on domestic sources of demand. Both positive and negative factors are at work here. On the positive side, a doubling of real wages since 1999, increased public pensions, a low propensity to save, improved access to credit and negative real interest rates have supported an acceleration in consumption growth over the past two or three years. Moreover, other things being equal, the expansion of the financial services industry, by region and breadth of retail products on offer, should ensure this continues.

Exhibit 1: Ruble Exchange Rate Appreciation



Source: Central Bank of the Russian Federation

Much private-sector activity still goes unrecorded via tax avoidance. RosStat inflates GDP data by 25% to reflect informal production, but some argue the black economy is even larger. This raises a question about the reliability of some official data, especially when making comparisons over long time periods.

On the negative side, the appreciation of the ruble over the past few years (a real effective appreciation of 65% from 1999 to 2005, per EIU) has eroded the manufacturing sector's competitiveness (see **Exhibit 1**). Also, an analysis of the sectoral composition of economic growth suggests that capacity constraints are emerging in several key sub-sectors (especially natural resource extraction and transportation). This reflects a consistent and long-term underinvestment in absolute terms (18% of GDP over the past five years) and relative to other emerging markets.[2] However, the growth rate of several key service sectors is rising, and construction activity remains buoyant, reinforcing the point that economic growth is depending more on domestic demand.

The contributions of the external sector and domestic demand to economic growth are becoming more balanced, but it is important not to underestimate Russia's dependence on oil and gas exports. Official data suggests the oil and gas sector form 9% of GDP. World Bank estimates from 2004, which consider the effect of transfer pricing,[3] indicate that oil and gas were 20% to 25% of GDP. Given the rise in commodity prices since the World Bank's report came out, oil and gas may now be an even higher share. Also, oil, fuel and gas constituted about two-thirds of export revenues in 2005. To the extent that high oil prices have stabilized the economy and have contributed to a rapid recovery in investment, it could be said that Russia's economy depends even more on volatile international commodities markets than before the ruble crisis in 1998.

Toward Sustained Performance

Economic growth is expected to moderate slightly over the short term as high oil prices and increases in fixed investment offset sluggish output growth in capacity-constrained sectors and a further appreciation of the ruble. Real GDP growth is expected to average about 6% this year and next (see **Exhibit 2**). Over this time, government finances will likely remain robust, and the risks to liquidity in the corporate sector and banking system are limited.

Over the medium term, growth is expected to moderate further – EIU anticipates that Russia's economy will grow at an average annual rate of 5.2% in the next five years. The path of growth, however, will depend much on whether private-sector investment can be raised enough to address increasingly evident capacity constraints and severe sector and regional imbalances in the economy. Indeed, greater diversification of economic activity across business sectors and regions is among the key challenges facing the authorities.

A breakdown of industrial output shows a high dependence on heavy industries. Metallurgy, fuels and energy formed more than 35% of industrial output last year; light industry was less than 5%. Clearly the manufacture of consumer and high-tech goods contributes little to the economy. The source of output is also highly skewed by size of enterprise. EIU estimates that small and medium-size enterprises account for just 10% to 15% of Russian GDP[4] compared with about 50% in more advanced emerging economies and in developed markets. EIU attributes this

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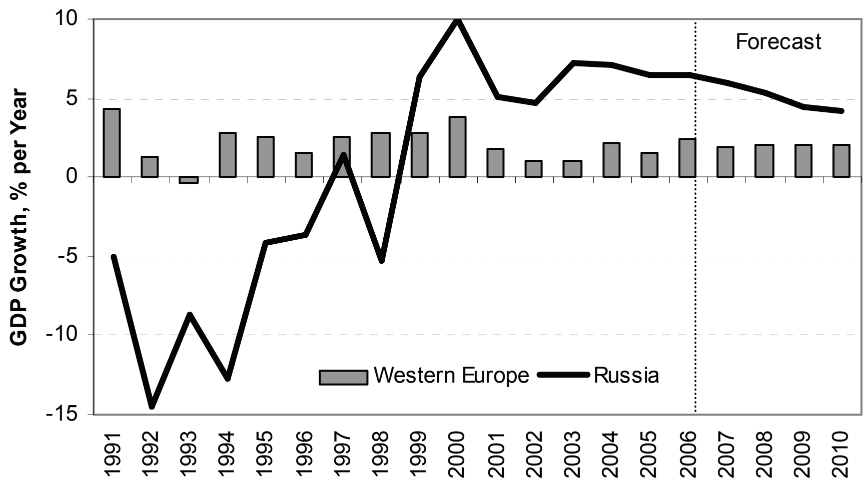
[2] Brazil, China and India, respectively, invested an average of 19%, 39% and 25% of GDP per year over this time.

[3] Transfer pricing is the common practice of oil companies selling their output cheaply to wholly owned subsidiaries in low-tax jurisdictions, which then sell the products at market price, thus enhancing profit margins. To the extent that subsidiaries are typically registered as trading (i.e., service-sector) companies, the practice overstates the true contribution of the service sector to GDP and understates the contribution of industry.

[4] The World Bank estimates that 20 large conglomerates account for almost 40% of industrial output.

to small business expansion being repressed by burdensome taxation, regulation and the anticompetitive practices of larger enterprises, often by exploiting ties with local bureaucracy.

Exhibit 2: Russian GDP Prospects Relative to Western Europe



Source: EIU

Geographic specialization and the promotion of specific industries within regions during the Soviet era created economic distortions. For example, several large cities in the Arctic Circle would not be sustainable without the central government's financial support. Also, Soviet planners' belief in the benefits of scale resulted in a small number of enterprises (sometimes as few as one) forming the basis of the entire local economy of a substantial city or region, making the closure of a bankrupt enterprise a politically sensitive issue. To the extent that size attracts diversity, larger cities have tended to deal with the transition better than smaller ones.

This specialization has also contributed to severe income inequality by region, which the nature of the economic recovery since 1999 has exacerbated.[5] According to a UN report, in 1991 the average income of the top decile was 7.8 times higher than that of the bottom decile. By 2001, this ratio had risen to 40. Due, in part, to a large decline in the portion of the population living below the official poverty line (from about one-third in 2000 to less than 16% at the end of 2005), this ratio has fallen greatly in the past few years but remains well above the 1991 level.

Similar differences are seen in regional GDP data (see **Exhibit 3**). The city of Moscow produces almost one-fifth of Russia's total GDP. The Moscow region accounts for a further 4%, as does the city of St. Petersburg. These regions and Tyumen (a main oil production area) create about 40% of Russia's output, with the rest coming from 84 other regions. Labor immobility from poor transport systems and housing shortages in larger cities contributes to these regional disparities.[6]

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[5] Export-led growth leads to a shift in incomes from wages and salaries to profits, while inflation has a disproportionate effect on lower-income groups.

[6] In September 2005, the government launched four priority National Projects (in health, education, housing and agriculture), which have become a main focus of economic policy in Russia. These projects, aimed at raising the standard of living, should also help alleviate regional disparities.

Exhibit 3: Gross Regional Product per Capita (% of national avg.)

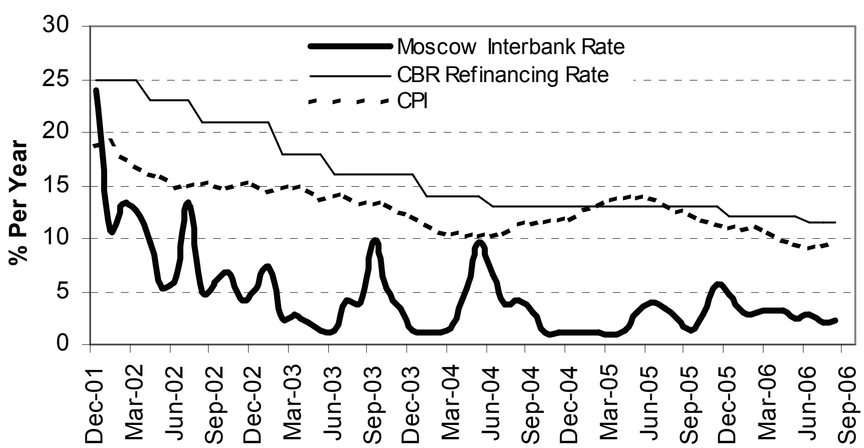
Top Five	%	Bottom Five	%
Tyumen Region	410	Republic of Adygeiya	38
Moscow City	235	Ivanovo Region	36
Krasnoyarsk Republic	138	Republic of Daghestan	35
Republic of Tatarstan	132	Republic of Tyva	30
Republic of Sakha (Yakutia)	121	Republic of Ingushetia	21

Source: UN Human Development Report for the Russian Federation, 2005

Equitable income distribution can help form a powerful middle class. Only 10% of Russia has reached middle-class or higher status, notes the Center for Living Standards (part of the Ministry of Health and Social Development).[7] The average monthly salary at the end of 2005 was about $300 ($600 in Moscow), according to EIU. However, given the projected rises in real wages and GDP per capita over the next five years (35% and 30%, respectively), great scope for a rapid expansion of the middle class exists. A strengthening middle class will help raise effective consumer demand and stimulate growth in industry. It will also strengthen institutions critical for the development of market economies, such as independent courts and democratic elections.

Inflation, now at 9.6%, is also a threat to the medium-term economic profile (see **Exhibit 4**). The authorities continue to target exchange rate stability relative to dollars and euros: the mix is 60% dollars and 40% euros. Due to stronger domestic demand, the dollar value of imports rose 25% in 2005, but the current account surplus hit a record (12% of GDP) due to rising prices of Russian exports. This contributed to a foreign currency reserve accumulation and a rapid rise of the money supply (37% at the end of 2005). This is fuelling domestic demand, putting more pressure on inflation, policy interest rates and the real effective exchange rate.

Exhibit 4: Inflation and Interest Rates



Sources: Bloomberg; Central Bank of the Russian Federation

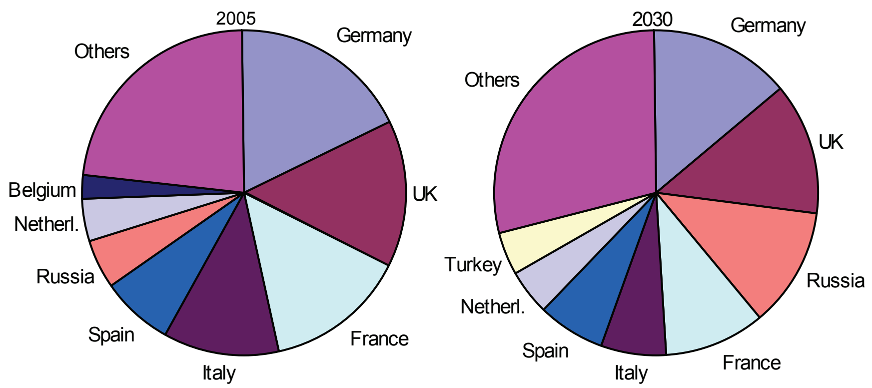
The Russian Central Bank allowed a modest nominal appreciation of the ruble in the early part of 2006, with a view to relieving pressure on inflation. The authorities have also introduced several measures to reduce inflation, such as regulating price increases of public utilities, restricting

[7] CLS defines a member of the middle class as a person who owns a home and has a monthly salary of at least $500.

wage growth in and borrowing of state-owned companies and reducing government expenditure, but these have typically proved ineffective.[8] The failure to adapt exchange rate policy remains among the key risks to price stability.

The longer-term outlook for the economy is much more uncertain. Russia is now the world's 15th largest economy by GDP. EIU forecasts average annual real growth over the next 25 years of 3.2%, which would raise GDP from about $790 billion now to roughly $5,900 billion in 2030.[9] If this and the projections for other countries occur, Russia would reach a global ranking of seventh and a European ranking of third, overtaking France, Italy and Spain (see **Exhibit 5**).

Exhibit 5: European GDP by Country 2005 and 2030



Source: EIU

In this central scenario, growth is very much front-loaded, with the first five years of the 25-year horizon seeing average annual growth of about 5.2% and the last five years about 2.8%. This is to some extent a reflection of Russia's adverse demographic profile, especially in terms of a declining and aging population.

A Looming Demographic Crisis?

Over the first half of this decade the population of Russia fell by 3.3 million to 143.2 million, according to the UN. The decline would have been greater but for an increase in net immigration. Moreover, population contraction is expected to continue: the latest UN estimates predict a 22% decline in population (to 112 million) by 2050.[10] The transition process has aggravated the already poor demographic outlook. While death rates have been rising since the 1960s (from a deteriorating health care system, stress and environmental degradation), death rates and infant mortality rates rose rapidly in the 1990s, while birth rates remained low.[11]

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[8] Moreover, the experience of other countries where such measures have been imposed suggests that the negative effect of the economic distortions created by these policy measures tends to outweigh the benefits.

[9] Calculated at market exchange rates.

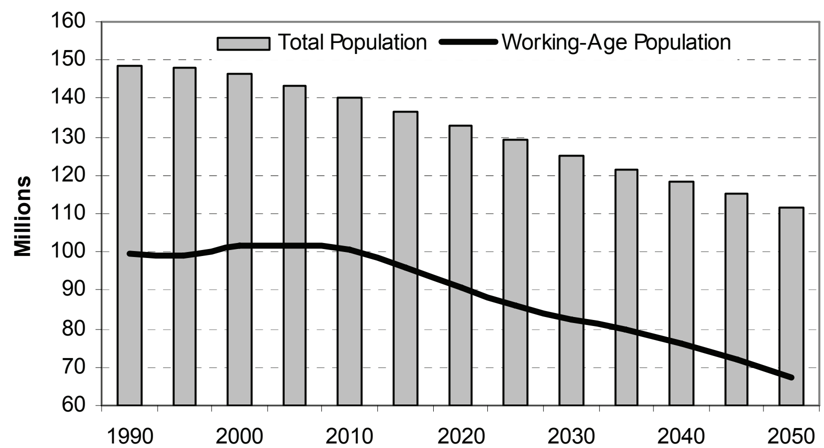
[10] This projection is based on the UN's median variant. For Russia, this assumes increasing fertility, above-average improvements in life expectancy and increasing international migration.

[11] Not least due to a very high abortion rate. According to the UN Human Development Report for the Russian Federation 2005, abortions outnumbered births two to one in the 1990s. This is partly a function of poverty. Despite a rapid decline in abortion since 2000, partly from increased living standards, abortions still outnumber births.

The fall in population occurred along with a decline in life expectancy. Total life expectancy at birth has fallen from just under 70 years in 1970 to about 65 years now,[12] largely due to the deterioration in male life expectancy, which at 58.9 years is now comparable with that of the 1950s, although recent signs show that this decline has stopped.[13] Nevertheless, the Russian population is aging rapidly (as in most higher-income industrialized economies), straining the pension system. Currently, 13.8 % of the population is over 65, and this is expected to rise to about 20% by 2030. The pay-as-you-go system cannot cope with these demographic trends, while the reform of the pension system is at an early stage.

Declining and aging populations do not bode well for the key driver of secular or structural occupier demand (especially of offices), namely the working-age population. This peaked in 2000 and is likely to fall by more than one-third by 2050 from current levels (see **Exhibit 6**). The Russian government estimates that an annual flow of about one million working-age migrants is needed to mitigate the effects of an aging and declining population from 2007. Against this background, labor supply is certain to become an ever-greater constraint on economic growth.

Exhibit 6: Russia's National Demographic Profile



Source: UNPD

Significant regional differences exist in the demographic outlook. Depopulation is much less severe in urban areas due largely to migration: Russia's urban population is expected to fall by about 6% over the next 25 years versus a decline of roughly 30% in rural areas over the same period. Many cities are already seeing population declines, but the prognosis for Russia's two largest cities, Moscow and St. Petersburg, is much more positive: both are likely to experience population increases over the next 10 years (3.5% for Moscow and 1.5% for St. Petersburg) and more modest growth thereafter, according to UN estimates.

[12] This compares with more than 78 years for the EU.
[13] According to the World Health Organization, 78% of all deaths among males of working age were from cardiovascular diseases, cancer or injuries.

Other Long-Term Challenges

To maintain high levels of economic growth over the long term, Russia must address several other major long-term challenges, which require significant structural reform.

- Severe environmental problems exist. Key concerns are water pollution, air pollution from industrial emissions and energy generation, increased waste generation (including nuclear waste) and soil contamination and land degradation leading to falling agricultural productivity. These issues require very large, long-term government investment.
- Transportation network quality is one of the main determinants of long-term economic prosperity. Russia's transportation infrastructure, which remains largely state owned, has deteriorated greatly in the past 20 years as a result of sustained underinvestment.
- The promotion of small and medium-size enterprises is crucial for more balanced and diversified growth. Improved business and governance standards and greater corporate transparency are among the reforms needed. Creating conditions where entrepreneurial activity is appropriately rewarded may help alleviate the current brain drain.
- Reform of the judiciary, law enforcement agencies and local/regional governance is also needed to improve the investment environment, reduce bureaucratic corruption and raise private-sector investment.
- While the land code now allows for the private ownership and free trade of commercial land, progress on improving the security of property rights is essential, not least in terms of promoting private-sector investment and the development of private credit markets.
- Greater integration of Russia into the global economy, for example, through its accession to the WTO (expected next year) should help accelerate reform.

An Improving Investment Environment

Russia's export revenues contributed to record trade and current account surpluses and record foreign reserves.[14] The economy, while facing a challenging development agenda, has limited capacity to absorb large surplus revenues and reserves. The government has tried to sterilize the inflow by amassing it in a Stabilization Fund, formed in January 2004, which is critical to macro stability and has helped prevent even more rapid exchange rate appreciation. Still in its infancy, this fund is large and will likely reach three trillion rubles ($115 billion) by the end of 2006. No longer just an insurance policy protecting the federal budget against changes in world oil prices, it is now an important part of national wealth. Even if oil prices fell sharply, the fund is already sufficient to ensure a balanced budget for several years. If, as is more likely, oil prices stay high, the fund will offer a partial solution to several current development challenges Russia faces.

The fund also is important in preventing a repeat of the 1998 government default and in repaying Russia's foreign currency debt. In January 2006, Russia repaid the debt owed to the IMF, while in August it paid off its Soviet-era debts to the Paris Club. Russia's budget and tax policy for

[14] This is due entirely to rises in the price of Russia's exports. The volume of exports fell by 5.6% in 2005 due in part to binding capacity constraints in important export sectors, but the current account finished the year at 12% of GDP, while foreign reserves stood at $182 billion. At mid-2006, foreign currency reserves were $260 billion – the world's fourth largest currency reserves behind China, Japan and Taiwan.

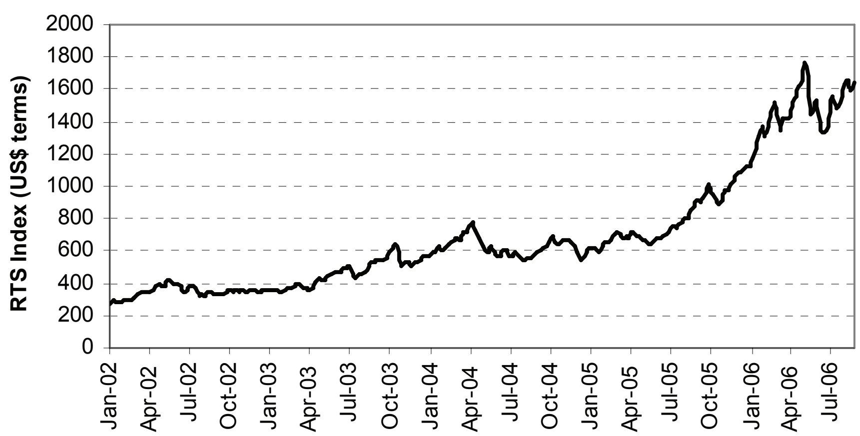
2007 aims to bring foreign debt from 9% of GDP as of late 2006 to 8.3% in late 2007, and to 7.5% in late 2009. Internal debt is likely to exceed foreign liabilities as early as 2008.

These dynamics have supported a robust strengthening of Russia's sovereign rating. Moody's was the first major rating agency to raise Russia to investment grade in 2003, while Fitch and S&P did so in 2004. Now Fitch and S&P rate Russia two notches above investment grade, following upgrades over the summer. Moody's rates Russia one notch above investment grade but is expected to raise its rating soon. All three continue to stress the remaining political and institutional risks, especially in the run-up to parliamentary and presidential elections at the end of January 2007 and spring 2008, respectively.[15]

These moves have raised investor confidence, which has shown itself in several ways. A large rise in FDI has occurred in recent years, despite lingering political uncertainty, exacerbated by the Yukos affair and the expansion of state intervention in strategically important companies or industries. FDI inflows grew by 40% in 2005 reaching $14.6 billion, supported by the recent improvements in the business climate and economic outlook.[16]

Equity markets, now an important source of finance for large companies, have seen a big rise in valuations and trading volumes lately. Russia's principal equity market index, RTS, rose by 85% in 2005 and by 55% in the first four months of 2006 (see **Exhibit 7**). The sharp corrections in May and June were in line with trends in emerging equity markets, sparked by a broader risk aversion among investors, and led to the postponement of several IPOs. Having fallen by one-third from early May's peak, the market has since recovered to within 10% of this high.

Exhibit 7: Russian Equity Market Performance[17]



Source: Bloomberg

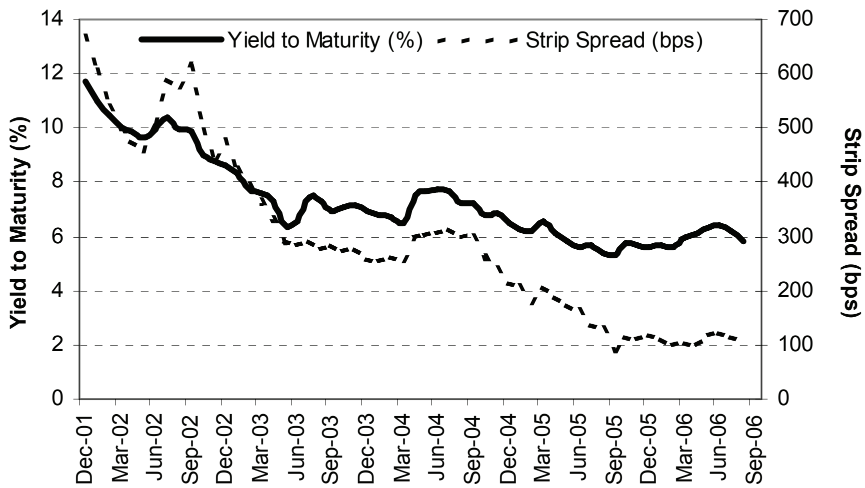
[15] In upgrading Russia in September, S&P said, "The upgrade is based on ongoing improvements in Russia's foreign exchange reserves coverage and a stronger balance of payment environment. Russia's economy is still benefiting from the global oil price boom, while policymakers continue to handle concomitant challenges to macroeconomic stability in a circumspect manner."

[16] FDI as a share of GDP (1.9% in 2005) remains low relative to other transition countries. In Poland, Romania and Ukraine last year, FDI as a share of GDP was 2.7%, 8.1% and 9.4%, respectively, according to EIU.

[17] The full extent of the May/June 2006 declines is obscured here by the frequency of the data used in this chart.

Increasing investor confidence has also raised international demand for Russian bonds. In common with many other emerging markets, Russia's sovereign yield spread over U.S. Treasurys has compressed rapidly over the past few years (see **Exhibit 8**). However, this repricing has been particularly acute for Russia, due, to a large extent, to a fall in the probability investors attach to the government defaulting on foreign currency debt amid the massive accumulation of foreign reserves and the prudent management of these reserves in the Stabilization Fund. At the start of 2006, the hard currency spread stood at 118 bps versus 478 bps three years earlier. While market volatility in May and June resulted in a widening spread, Russian government bond spreads are now as tight as ever (circa 100 bps).

Exhibit 8: Russian Government Bond Yield & Spreads Over U.S. Treasurys



Source: JP MorganChase

While this has clear benefits in terms of the cost to the government of raising long-term debt finance, it is also having a positive impact on the liquidity and pricing of ruble-denominated bonds, the market for which is small. As the government seeks to substitute domestic for foreign debt, the increased market size and liquidity will continue to help the corporate credit market in terms of companies' ability to meet their funding requirements through domestic bonds.[18]

Unlike Central and Eastern European markets, Russia's private equity landscape is characterized by an abundance of local capital (from wealthy individuals and cash-rich businesses seeking to invest in noncore business activities), and a limited presence of international private equity fund managers. The European Bank for Reconstruction and Development (EBRD) notes that the provision of private equity capital from institutional investors remains volatile, highly cyclical, and hampered by a lack of corporate management skills, ownership disputes and regulatory uncertainties. However, improvements in the business climate and economic outlook (as reflected in the upgrading of sovereign ratings) are contributing to more international private equity investors seeking to penetrate the market.

[18] Maturities in the corporate credit market remain limited. According to EBRD, 71% of bonds issued have maturities of less than one year.

These dynamics are also starting to have an impact on private debt markets. After the 1998 collapse, bank lending has been slow to pick up: banks still only finance about 10% of private sector investment, compared with 50% in developed markets. Corporate lending continues to be hampered by a lack of transparency in the corporate sector, a legal framework that favors borrowers over lenders, a lack of capital and the dominant position of a small number of banks.[19]

Reform in the financial-services sector and phasing out the special privileges of a few banks should lead to a rapid expansion of private debt markets. Unlike elsewhere in Central and Eastern Europe, where foreign banks have driven the modernization of the banking sector, Russia has had little penetration from foreign banks. The barriers to entry remain formidable, but the past few years have seen some international banks open offices in Moscow and St. Petersburg to serve their international clients. While the opening of the banking sector to foreign competition remains a subject of negotiation in Russia's upcoming accession to the WTO, ongoing liberalization should encourage further foreign entrants over the short to medium term. This should lead to increased flexibility of loan terms on offer and to more attractive pricing.

According to EIU, some improvement in the overall business environment has occurred over the past few years. EIU's business environment rankings show that since 2001 Russia's score has risen from 5.0 to 5.6 (out of 10). Some progress has taken place on deregulation and a reduction of administrative barriers to business (such as licensing, registration, inspections, land use and taxation). Positive changes have also occurred in some of the institutions enforcing corporate governance laws and regulation. Progress, however, has been slow, and the enforcement of contracts and property rights has been uneven. Moreover, corruption in the bureaucracy, which is difficult to measure, appears to have risen in recent years, according to surveys by Transparency International, EBRD and the World Bank, among others.

The Real Estate Market

The improving investment environment is one factor that has put Russia's real estate market on international investors' radar screens over the past few years. Most investors are pursuing opportunistic strategies, engaging in development activity, partnering with local operators (either via joint ventures or the acquisition of controlling interests), but investors increasingly seek to acquire existing and leased buildings. Demand is driven by a growing number of institutional-investor-backed private equity funds and public vehicles (most notably listed on London's AIM) with Russian or Eastern European strategies. To-date, investor demand has focused almost entirely on Moscow and (to a much lesser extent) on St. Petersburg. While these cities dominate in terms of population, levels of business activity and the volume of investment-grade stock, 11 other Russian cities with populations of over one million might offer more adventurous investors opportunities over the longer term, especially in the retail and residential sectors (see **Exhibit 9**). To-date, however, exit risk/liquidity in these second-tier cities is completely unproven.

[19] The banking sector is dominated by Sberbank, a state controlled institution, which inherited an extensive network of branches from the Soviet era. This bank accounted for about 30% of the corporate lending market at the start of 2006. Its dominant position has been one of the main impediments to a competitive banking sector.

Exhibit 9: Russia's Largest Cities

	Population (millions)	Distance from Moscow (km)
Moscow	10,406,578	-
St. Petersburg	4,601,000	630
Novosibirsk	1,405,569	2819
Jekaterinburg	1,304,251	1420
Nižnij Novgorod	1,297,550	488
Samara	1,151,681	867
Omsk	1,142,773	2243
Kazan'	1,110,022	724
Čel'abinsk	1,095,053	1500
Rostov-na-Donu	1,057,958	957
Ufa	1,036,026	1169
Volgograd	1,032,938	909

Source: www.citypopulation.de/Russia.html

General Characteristics

Unlike the real estate markets of many other Central and Eastern European cities, Moscow and St. Petersburg have abundant local capital (from wealthy individuals and large enterprises seeking to diversify away from core business activities). When opportunistic investors entered Central European markets in the mid-1990s, their capital filled a void and played an important role in the modernization of stock. The lack of local capital also made for a less competitive acquisition environment. In Russia, competition for projects/investments between local and foreign investors is fierce. Moreover, the rigorous due diligence procedures that international investors quite rightly undertake in this highly immature and opaque market can hinder them relative to more nimble local investors who can execute much more rapidly.

The high propensity for corporations to own rather than lease the property they occupy adds to the competitiveness of the acquisition environment confronting the international investor. As a byproduct, strata ownership, where occupiers own the floors/units they occupy and a share of the common space, is prevalent. Thus, investment assets tend to have a higher portion of international tenants (who prefer leasing) than is common in most other European markets.

Due to years of underinvestment, the existing stock of real estate increasingly fails to meet the needs of tenants against the backdrop of rapid economic growth over the past few years and the transition to a service-based economy. Most stock is class C, and much of that would be considered obsolete by Western standards. The shortage of prime space has led to strong rental growth in the past few years, which has raised occupation costs to among the highest in Europe.

The privatization of the construction sector in the early 1990s, increasing security of property rights and improvements in the institutional framework that allow risk to be appropriately rewarded, plus the acute lack of modern space, have all led to very high levels of construction activity over the past few years. The development pipeline across the three main commercial property sectors is substantial and growing. Anecdotal evidence suggests that construction costs have risen by 25% in the past 12 months as a result of capacity constraints (shortages of skilled labor and experienced management) and increases in material prices, especially steel. This is contributing to longer construction times and is lowering the completion rate.

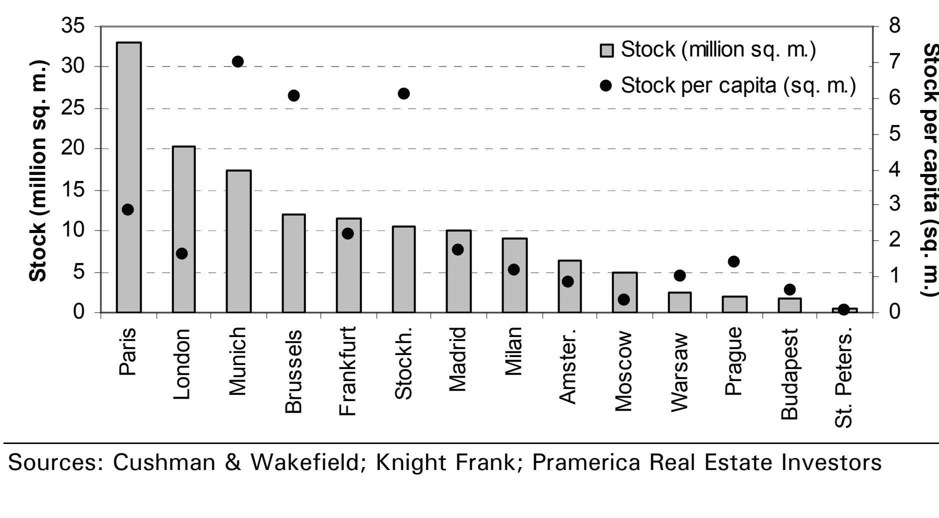
Market transparency is improving. All the major international property agents/consultants have established large offices in Moscow and are providing increasingly detailed analysis of the market. However, the number of transactions involving brokers remains small and, as such, pricing remains opaque, particularly outside the capital. Anecdotal evidence suggests that in the absence of adequate comparables, several brokers did not reduce valuation yields during 2005, despite evidence of an increase in investor demand.

Moscow

With a metropolitan area population of 14.5 million, Moscow is Europe's largest city.[20] Once the center of the Soviet empire, Moscow is leading the country's transition to a more service-based economy. The occupier base contains a large government sector and associated organizations, headquarter buildings for larger industrial and financial-sector corporations and smaller service-sector businesses. The city has seen rapid growth in the past few years, in population and economic activity and, as a result, the transport infrastructure is under increasing pressure. Road network improvements are under way (most notably, adding another ring road to the existing four), but it will be a few years before they are completed.

Moscow still has a shortage of modern office space. At mid-2006, the stock of grades A and B was 4.9 million square meters, per Knight Frank (see **Exhibit 10**). While larger than the stock in Warsaw, Prague and Budapest, this is small compared with the main Western European markets, especially given Moscow's population.

Exhibit 10: Stock and Stock per Capita



Sources: Cushman & Wakefield; Knight Frank; Pramerica Real Estate Investors

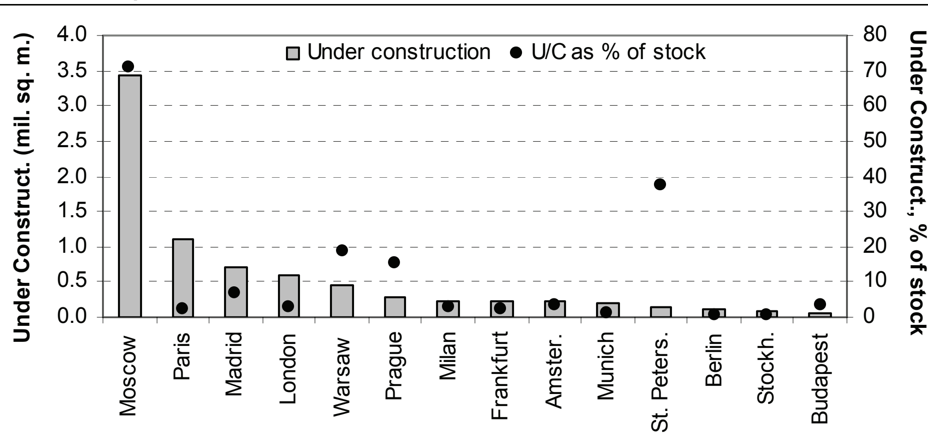
[20] London and Paris have metropolitan populations of 12.5 million and 11.6 million, respectively. In fact, the population of Moscow is larger than that of 18 countries in the EU25.

Demand for modern office space is now very high. Gross take-up is running at more than one million square meters per year,[21] both from expansion and the need to upgrade from poorer quality stock. Moreover, with availability very low, latent demand for space is significant. Unemployment in the city is lower than the national average (circa 7%), and the participation rate is high. Nevertheless, significant scope for growth in office-based employment remains due to a relatively high level of underemployment in the city.

At midyear, vacant space amounted to less than 4% of stock. This, combined with strong demand, has resulted in rapid rental growth in the past few years. Prime rents stand at $700 to $800 per square meter per year, making office space in Moscow more expensive than any other city in Europe except London and Paris. Interestingly, there seems to be little discrimination by location. While space close to the Kremlin and in the CBD tends to command a premium, the premium is relatively small, even compared with noncentral locations. This may stem from the travel time and costs of working in the city center, especially given the very congested transport infrastructure, but it could also be a function of scarcity.

Rising rents and sales prices are two factors that have contributed to a very high level of construction activity (see **Exhibit 11**). At the end of 2Q06, 3.4 million square meters of office space was under construction.[22] The completion of this space will increase the existing stock of modern office space in the city by 70%. Despite capacity constraints (skilled labor shortages and a lack of good quality construction companies), the pace of new construction continues to rise. Construction times are growing, while inspections of premises by the State Commission face greater delays, and time frames for commissioning are consistently deferred to later dates.

Exhibit 11: Space Under Construction



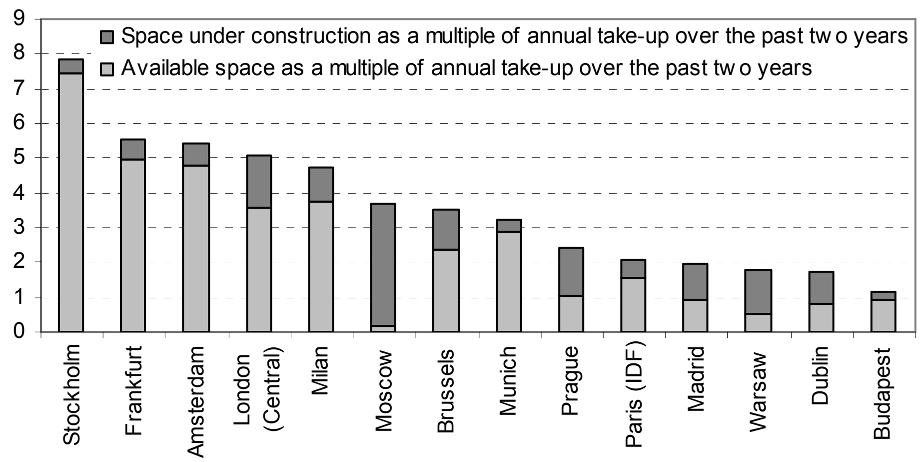
Sources: Cushman & Wakefield; Knight Frank; Pramerica Real Estate Investors

According to Knight Frank, the Moscow authorities intend to reduce the pace of construction of nonresidential premises in the city center, with a view to intensifying construction at the MIBC Moscow-City site – a huge development along the Moscow River, three miles southwest of the Kremlin, which the authorities hope will become the country's main financial district.

[21] Only Paris has a higher take-up level in absolute terms, but it is a much larger market (33 million square meters, excluding decentralized Ile de France locations).
[22] This is more than three times the volume of space under construction in Paris.

While very substantial, some evidence suggests that the market might be able to absorb this new space if take-up continues at current levels. Adding the volume of available space to that under construction and comparing it with recent take-up levels, Moscow's situation is certainly not extreme in the context of other European office markets. At about 3.5, the ratio of space vacant and under construction to annualized take-up over the past two years is much lower than in the Frankfurt and Amsterdam markets, although higher than Madrid and Paris (see **Exhibit 12**).[23]

Exhibit 12: Space Under Construction or Vacant as a Multiple of Annual Take-Up



Sources: Cushman & Wakefield; Knight Frank; Pramerica Real Estate Investors

Nevertheless, the volume of space in the development pipeline is the biggest risk to the stability of Moscow's office market. The level of latent demand for space is unknown, but a real risk of oversupply exists, similar to that in Warsaw, Prague and Budapest from the mid-'90s onward, which resulted in rental declines of 50% or more in subsequent years. A simple cross-sectional rental model suggests that a stabilized rental level reached when the Moscow office market enters a more mature phase might be about $450 per square meter for prime space. This new supply is likely to more severely affect class-B space (in terms of rental levels and tenant quality) and ought to lead to greater discrimination by location. It should also speed the process of submarket formation that is now occurring and lead to greater differentiation of the occupier base in these submarkets.

Sale prices are rising rapidly. The price per square meter of class-A offices is now $4,000 to $7,000, while the price per square meter of class-B offices is $3,500 to $4,500, per Knight Frank. Agents are now quoting prime office yields of sub-9%, down from 13% a year ago, but the transaction evidence to support these levels remains thin. These levels are a 300-bps premium over Warsaw and Prague, but it is not clear that this is sufficient to compensate investors for the

[23] This analysis is based on gross take-up rather than on net absorption. As such, it fails to take account of differences in expansionary demand across markets and, by implication, the volume of existing space released by companies taking up new space. If a small portion of take-up in Moscow is a result of expansionary demand, vacancy rates could rise very sharply, even if take-up levels remain high. That said, much of the space released is likely to be class C or functionally obsolescent and would therefore drop out of the data.

additional risks associated with Moscow. Also, at current finance costs (circa 350 bps over U.S. LIBOR) little potential for positive income leverage exists for prime offices.

Against this background, other sectors may well offer international investors more defensive opportunities. The Moscow region is likely to become one of Russia's largest logistics centers. The stock of modern industrial space amounts to less than three million square meters. Growing demand for international-standard warehousing and logistics management, combined with increasing interest in the sector from institutional investors (domestic and international), has contributed to several potential large-scale logistics and industrial park projects in the development pipeline. Local authorities are also encouraging large international industrial developers to tender for the creation of Special Economic Zones designated for industrial use. Against this background, the volume of modern industrial space under construction (now 430,000 square meters) is set to grow rapidly.

The retail sector is also seeing a dramatic transformation. Several years of rapidly rising real wage growth and improved access to credit markets have led to real consumption growth of over 10% in the past few years. The retail sector is evolving rapidly to meet the demands of a growing middle class with increasing disposable income. The sector has seen several mergers and acquisitions over the past 12 months and a number of retailers have undergone IPOs or are preparing to list in coming months. This will likely improve the transparency of the sector.

Developers continue to announce large-scale shopping center projects in the Moscow region. Many of the new centers completed in Moscow over the past five years have been poorly designed or built. The next few years will see the development of better-conceived and constructed shopping centers and an improvement in existing projects as they expand. Construction is planned or under way on several high-profile schemes, and demand is high from both retailers and investors.

St. Petersburg

With a metropolitan area population of 5.5 million, St. Petersburg is Russia's second largest city and Europe's eighth largest. Europe has influenced this city more than Moscow, partly due to its port (the largest in northwest Russia) and the use of European architects in the 18th century, whose buildings remain. Despite the city's size and importance, the real estate market is very small. The stock of modern office space amounted to just 0.4 million square meters, and only a fraction of this would be considered class A by Western European standards. The existing stock of office space is highly centralized, but with most development activity now occurring outside the center, the market will likely become highly decentralized over the next decade.

The industrial and retail sectors are equally immature. The stock of modern industrial facilities amounts to 0.5 million square meters, according to Jones Lang LaSalle, which is especially low given the importance of the port.[24] This amount is expected to double over the next two to three years, with much of the new space located around the new ring road. Vacancy is now very

[24] Jones Lang LaSalle has a partial explanation. A large volume of the tonnage passing through the port is distributed from Moscow, not St. Petersburg, probably because of poor interregional transport infrastructure.

limited (less than 1%), with demand for space increasingly driven by retailers. Amid rising real incomes and greater consumer sophistication, the city has seen a rapid growth in shopping area development. About 10% of all Russia's modern shopping centers are in St. Petersburg, and with construction activity increasing, this share is set to rise.

Opportunities in the Residential Sector

Rising wealth levels are also affecting the residential sector all over Russia. Years of underinvestment have resulted in severe housing shortages, particularly in larger cities, and the quality of existing stock is poor.[25] With housing being one of the four national priority projects, government investment in the sector is expected to rise significantly. Much of this support is likely to focus on affordable housing for lower-income groups. The Federal Agency for Construction aims to double the volume of new housing nationally to about 80 million square meters by 2010.

Rising income and better access to credit markets, however, is increasing demand for better quality housing. *The Economist* estimates that less than 8% of residential purchases are now financed with a mortgage. As the mortgage market matures, the level of private ownership is expected to rise rapidly, which should raise the demand for better quality housing and increase the level of private ownership, which is now very low.

Potential Challenges for Investors

While Russia offers real estate investors a diverse and growing set of opportunities, significant barriers to entry exist for international investors.

- An abundance of local capital (largely private) can execute much more quickly than institutional investors undertaking thorough due diligence. This can also make for an aggressive acquisition environment and competitive pricing.
- Differing perceptions of risk between local and international investors can result in international investors being less competitive. This difficulty ensures that a reliable local presence in these markets is essential.
- There remains significant counterparty risk: the investment market remains nascent and highly opaque, very few deals are professionally marketed, and relatively few professional vendors are in the market now.
- The institutional framework necessary to support foreign investment is immature. Uncertainty remains as to the security of property rights in some regions, the judicial system continues to undergo reform, and political and regulatory risks remain significant. Corruption is still evident in the bureaucracy, and recent events show that Russia is far from a mature democracy.
- Tax legislation relating to real estate investment changes often. This lack of stability creates difficulties for structuring acquisitions.

[25] According to EIU, about 30% of Russia's population lacks running water, electricity or both.

- Local capital markets are underdeveloped. Foreign banks have been slow to penetrate the market. Credit margins remain wide, and loan terms on offer are often inflexible, with banks typically enforcing aggressive amortization schedules.[26] With debt priced relative to U.S. LIBOR and a credit margin of 300-350 bps for plain vanilla transactions, the potential for positively leveraging the income return is limited for prime assets. As a result, the optimal capital structure for an asset deal will often differ substantially from similar opportunities in other European markets.
- Real estate market risks are also higher. For example, the market remains highly opaque, exit liquidity is unproven, building quality is typically lower than in more mature markets, there are some questions as to the affordability of rents at current levels and a risk that the long-run sustainable level of rents will be significantly below current levels.

Among other things, these factors raise the burden of due diligence. That said, Russia offers a yield premium over Western Europe of 400-600 bps depending on sector and city. In a low-yielding global investment environment, this premium looks attractive and for well-structured, well-conceived deals this could be sufficient to compensate investors adequately for the additional risks of this market.

Conclusion

Huge increases in Russia's foreign reserves, on the back of high international oil and gas prices, have provided a very great boost to growth in the past few years. Prudent management of these reserves by the authorities through the Stabilization Fund has improved the medium-term economic outlook and has had a positive impact on the investment environment in Russia. Also, the reserves provide the Russian government with the opportunity and resources to address some of the longer-term, deep-rooted structural problems the country faces.

Moscow is now Europe's most dynamic real estate market, with both construction and take-up activity exceeding levels in all other markets. The local economy is leading the country's transition to a more diversified economic structure. The construction boom under way is generating rapid growth in the volume of investment-grade real estate. While the barriers to entry for foreign investors are large, the institutional framework needed for a substantial, liquid investment market to emerge in which foreign investors can actively compete is evolving quickly. Foreign investment remains focused on development opportunities executed through joint-venture relationships with experienced and reliable local partners, but demand for standing investments is increasing. Against this background, Moscow could, over the long term, become a strategically important investment market for institutional investors seeking European real estate exposure.

[26] To some extent this reflects banks' risk premium and uncertainty associated with changing tax legislation and concomitant issues surrounding deal structuring.

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